No. 95-2084

In the Supreme Court of the United States

OCTOBER TERM, 1995

HAROLD CHAKALES AND LINDA CAROL CHAKALES,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether the increased rate of interest on a tax underpayment "attributable to tax motivated transactions" (26 U.S.C. 6621(c) (Supp. IV 1986)) is applicable when the taxpayer, acting without any profit motive, invested in a tax shelter program that lacked economic substance.

2. Whether the addition to tax for tax underpayments resulting from negligence (26 U.S.C. 6653(a) (Supp. IV 1986)) is applicable on the facts of this case.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 2-9) is reported at 79 F.3d 726. The opinion of the Tax Court (Pet. App. 10-19) is reported at 68 T.C.M. (CCH) 479.

JURISDICTION

The judgment of the court of appeals was entered on March 27, 1996. The petition for a writ of certiorari was filed on June 25, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In 1984, the Commissioner of Internal Revenue issued a notice of deficiency that disallowed the loss deductions claimed on petitioners' 1980 and 1981 income tax returns. These losses were claimed in connection with petitioners' participation in a tax straddle program operated by First Western Government Securities, Inc. (Pet. App. 10a-11a). The notice of deficiency also asserted that petitioners were liable for an addition to tax for negligence under 26 U.S.C. 6653(a) (Supp. IV 1986).[1] Petitioners sought review of the Commissioner's determination in the Tax Court, where the Commissioner asserted that petitioners were also liable for the increased rate of interest imposed by 26 U.S.C. 6621(c) (Supp. IV 1986) on any underpayment of tax attributable to a tax-motivated transaction (Pet. App. 3a, 10a-11a).[2]

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[1] Section 6653(a)(1) imposed an addition to tax equal to five percent of an underpayment if any part of the underpayment was due to negligence or disregard of rules or regulations. Section 6653(a)(2) imposed an addition to tax equal to 50% of the interest payable under Section 6601 on the portion of the underpayment attributable to negligence. 26 U.S.C. 6653(a)(2). Section 6653 was repealed by the Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(c)(1), 103 Stat. 2399. Provisions similar to Section 6653(a) are now found in Section 6662. See 26 U.S.C. 6662(b)(1) and (c).

[2] Section 6621(c) provided for an interest rate of 120% of the normal interest rate on substantial underpayments of tax attributable to "tax motivated transactions." An underpayment was substantial if it exceeded $1,000 (26 U.S.C. 6621(c)(2)), and a "tax motivated transaction" was defined to include, *inter alia*, "any sham or fraudulent transaction" (26 U.S.C. 6621(c)(3)(A)(i) and (v)). Section 6621(c) was repealed for tax returns due after December 31, 1989, by the Omnibus

2. More than 3,000 cases were pending in the Tax Court involving taxpayers, such as petitioners, who claimed losses generated from their participation in the First Western program. Several of these cases were consolidated for trial as a test case in *Freytag* v. *Commissioner*, 89 T.C. 849 (1987), aff'd, 904 F.2d 1011 (5th Cir. 1990), aff'd on other grounds, 501 U.S. 868 (1991).

The evidence in *Freytag* showed that the participants in the tax straddle program would inform First Western of the amount of tax losses that they wished to obtain and First Western would then charge the participants fees of 7% to 8% of the desired losses. The fees supposedly were paid for contracts to take or deliver government mortgage-backed securities approximately 14 to 22 months in the future. No such futures market existed for those securities, however, and the securities were never delivered. Instead, First Western created investment portfolios on a computer in which the investors would simultaneously contract to buy securities on one future date and sell similar securities on another date. The straddle scheme was designed to create current deductible losses with offsetting, deferred capital gains in the same amount. 904 F.2d at 1013-1014, 1016.

The Tax Court concluded in *Freytag* that the Commissioner had properly disallowed the loss deductions because "[t]he transactions between First Western and its customers were illusory and fictitious" and were "entered into primarily, if not solely, for tax-avoidance purposes." 89 T.C. at 875-876. Because the transactions were "illusory and fictitious"

Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(b) and (d), 103 Stat. 2399, 2400.

and represented "shams," the Tax Court concluded in *Freytag* that additional interest under Section 6621(c) was due on the underpayments in tax. 89 T.C. at 886-887. The court also sustained the additions to tax for negligence. *Id.* at 887-888.

The Fifth Circuit affirmed the decision of the Tax Court in *Freytag*. The court observed that, on the record of that case, the Tax Court "could not help but" conclude that the First Western transactions were shams. 904 F.2d at 1016. The court stated that it was "ludicrous to suggest that these petitioners had anything but a most fleeting interest in a potential economic gain" with respect to those transactions. *Id.* at 1017 n.11. The court therefore affirmed the disallowance of the taxpayers' claimed loss deductions and the imposition of the additions to tax for negligence imposed in *Freytag*. *Id.* at 1017.[3]

3. After the final decision in *Freytag*, petitioners in the present case conceded that their transactions with First Western were conducted in the same manner described in *Freytag* (Pet. App. 12, 15). They further stipulated that the "losses" reported on their 1980 and 1981 income tax returns could not properly be recognized for tax purposes (*id.* at 3, 5, 12, 15). The only issues remaining for consideration were thus petitioners' liability for the addition to tax for negligence under Section 6653(a) and their liability

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[3] The taxpayers in *Freytag* challenged the imposition of the increased interest rate for tax motivated transactions under 26 U.S.C. 6621(c) (Supp. IV 1986) only on the theory that the statute could not be applied retroactively. The court of appeals did not consider that issue in *Freytag* because the taxpayers had not properly preserved it. 904 F.2d at 1017-1018 n.12.

for additional interest under Section 6621(c) (Pet. App. 3, 12).

The Tax Court sustained the Commissioner's determinations. The court noted that the increased rate of interest provided in Section 6621(c) is expressly applicable to "sham" transactions (26 U.S.C. 6621(c)(3)(A)(v) (Supp. IV 1986)) and that petitioners conceded that their transactions were identical to the transactions found to be shams in *Freytag* (Pet. App. 15). The court further found that petitioners lacked a profit motive for investing in the First Western program, although the court emphasized that such a finding was not a prerequisite to the imposition of increased interest under Section 6621(c)) (*ibid*).

The Tax Court further concluded that petitioners were liable for the addition to tax for negligence under Section 6653(a). The court concluded that petitioners had not exercised "due care" and had "entered into these transactions with the primary, if not sole, objective of obtaining the tax loss" (Pet. App. 18-19).

4. The court of appeals affirmed (Pet. App. 2-9). The court noted that, under the plain language of the statute, a tax motivated transaction expressly includes "any sham * * * transaction" (26 U.S.C. 6621(c)(3)(A)(v) (Supp. IV 1986). The court therefore agreed with the Commissioner and the Tax Court that the penalty applies simply upon a finding that the transaction was a sham (Pet. App. 4). Because petitioners conceded that the claimed losses from the First Western transactions were correctly disallowed under *Freytag* as sham transactions, the Section 6621(c) penalty properly applied (Pet. App. 4-5). The court noted that petitioners contended that the Section 6621(c)(3)(A)(v) penalty cannot be applied unless the taxpayer entered into the transaction

without a profit motive. The court concluded that it did not have to decide that question, however, because petitioners were not the "innocent victim of a fraudulent scheme" that was entered into "in good faith for profit" (Pet. App. 5). To the contrary, as the Tax Court had found, petitioners "entered into these transactions with the primary, if not sole, objective of obtaining the tax loss" (*ibid*).

The court also sustained the Tax Court's finding that petitioners were subject to the addition to tax for negligence under Section 6653(a). The court rejected petitioners' factual contention that they reasonably relied on the advice of counsel in entering into these sham transactions. The "advice" given by petitioners' attorney, on which petitioners claim to have relied, "was little more than a generalized statement that [petitioners] could lose money on the transaction" (Pet. App. 8).[4]

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. Under Section 6621(c) of the Internal Revenue Code as then in effect (see note 2, *supra*), an underpayment in tax that is in excess of $1,000 and that is attributable to "tax motivated transactions" is subject to an increased rate of interest. 26 U.S.C. 6621(c) (Supp. IV 1986). The term "tax motivated transaction" is defined expressly to include "any sham or

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[4] The court noted that petitioner Harold Chakales was "vague at best about just what 'advice' he had received" from his attorney (Pet. App. 8-9).

fraudulent transaction." 26 U.S.C. 6621(c)(3)(a)(v) (Supp. IV 1986).

In *Freytag* v. *Commissioner*, *supra*, the Tax Court found that the transactions between First Western and its customers were "illusory and fictitious and not bona fide" (89 T.C. at 875, 877) and were nothing but "shams" (*id.* at 887). These findings were upheld on appeal. 904 F.2d at 1015-1016. In the present case, petitioners conceded that the loss deductions they claimed with respect to the transactions with First Western were identical to those described in *Freytag* (Pet. 9; Pet. App. 12, 15). The Tax Court and the court of appeals thus correctly concluded that the transactions with First Western were "shams" that triggered imposition of the increased rate of interest under Section 6621(c). See also *Howard* v. *Commissioner*, 931 F.2d 578, 582 (9th Cir. 1991) (when a taxpayer acquiesces in a trial court's determination that he is liable for an underlying deficiency because the transaction in question was a sham, the taxpayer is precluded from challenging on appeal the imposition of increased interest under Section 6621(c) for substantial underpayment resulting from a sham transaction).

Petitioners nonetheless claim (Pet. 14-16) that it was improper for a substantial underpayment penalty to be assessed for their sham transactions. They assert that a transaction cannot be a sham unless the court finds not only that it lacked economic substance but also that the individual taxpayer entered into it without a profit motive. As the court of appeals correctly stated, however, the issue that petitioners desire to frame is not presented under the facts of this case (Pet. App. 5):

> We need not decide the appropriate application of section 6621(c)(3)(A)(v) to the case of an innocent victim of a fraudulent scheme who entered it in good faith for profit. This is not such a case. The Tax Court made specific findings rejecting Chakales' assertion of a profit motive. * * * After reviewing Chakales' course of conduct with respect to his investment, the court found that "[t]he only rational explanation for any of this is that petitioner entered into these transactions with the primary, if not sole, objective of obtaining the tax loss." [68 T.C.M.] at 484. That finding is not clearly erroneous.

As the Tax Court properly concluded, petitioners' contention that they possessed a profit motive in entering into "the First Western transactions is simply cut from whole cloth" (Pet. App. 18). That factual conclusion, concurred in by both courts below, does not warrant further review. See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985).

2. The court of appeals correctly upheld the addition to tax imposed against petitioners for negligence. Petitioners contend that a negligence determination was inappropriate on the theory that they reasonably relied on advice of counsel. That factual contention was rejected by both courts below and does not warrant further review. As the court of appeals stated, although petitioners were "vague" about the nature of the advice on which they claim to have relied, the only advice that they actually received was that they "could lose money on the transaction" (Pet. App. 8-9). "Advice" of that nature cannot shield a taxpayer from the penalty imposed on tax under-

payments resulting from negligent disregard of the tax laws.

This case does not conflict with the decisions of the Fifth Circuit in *Chamberlain* v. *Commissioner*, 66 F.3d 729 (1995), and *Durrett* v. *Commissioner*, 71 F.3d 515 (1996), even though those decisions concluded that a negligence penalty was inappropriate in cases involving other taxpayers who participated in the First Western tax shelter. Those Fifth Circuit decisions do not apply a different legal test than was applied in the present case. Instead, they apply the *same* legal test to diametrically different sets of facts. Unlike the situation here, where petitioners failed to establish that their negligent position was based upon reasonable reliance on expert advice, the taxpayers in *Chamberlain*, 66 F.3d at 733, and *Durrett*, 71 F.3d at 518, had made such a showing. As the court of appeals noted in this case (Pet. App. 9), in *Chamberlain*, the Fifth Circuit found (66 F.3d at 733) that the "expert advised that there was 'a good faith, supportable position' concerning the deductibility of the loss." There is thus no conflict among these decisions to warrant further review.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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